## F. Capital Structure

### 1. Overview

111. Part 65 requires the RHCs to calculate and submit the percentages of equity, debt, and preferred stock in their capital structures for inclusion in the record in represcription proceedings.[311] In the 1990 represcription proceeding, we used the composite of the RHCs' capital structures to compute the cost of capital for LEC interstate access service.[312] In the Notice, we indicated that this approach might remain acceptable for determining an appropriate capital structure for the interstate access operations of the rate of return LECs. We invited comment, however, on three alternatives to using RHC capital structure data: using the composite capital structures of LECs that have $100 million or more in annual revenue or their holding companies; using a composite of a representative sample of the rate of return LECs' capital structures; and selecting a fixed capital structure based on one of the capital structures mentioned above. We asked the commenters to address whether the various alternatives would produce credible capital structures and would also further our goal of simplifying future represcription proceedings, without providing incentives for manipulation.[313]

112. We also invited comment on whether we should separately identify short-term debt and preferred stock components within the capital structure and, if so, how we should perform that identification.[314]

### 2. Comments

113. LEC commenters and USTA generally support using a composite of the BOCs' capital structures, as reflected in ARMIS data, to determine the capital structure component of our overall cost of capital calculation.[315] These commenters contend that the BOCs' capital structures reflect the business risks LECs face.[316] They assert that ARMIS reports provide all the data needed to compute the BOCs' composite capital structure, and that

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[311] 47 C.F.R. §65.300.

[312] 1990 Represcription Order, 5 FCC Rcd at 7510, para. 28.

[313] Notice, 7 FCC Rcd at 4699, paras. 84-86.

[314] Id. at para. 86.

[315] Centel Comments at 14-16; SNET Comments at 5; SWBT Comments at 3; United Comments at 6-8; USTA Comments at 58-59.

[316] Centel Comments at 16; Rochester Comments at 25; SWBT Comments at 3; USTA Comments at 59.

reliance on these data will reduce the burdens of the represcription process.[317] Several LECs and USTA maintain that the RHCs have no incentives to manipulate LEC capital structures and that the BOCs issue their own debt.[318] They argue that state regulatory commissions and independent rating agencies scrutinize the BOCs' capital structures.[319] USTA further points out that all LECs with annual revenues of $100 million or more, including the BOCs, have bonds held by independent investors who also monitor and assess those LECs' capital structures.[320]

114. MCI recommends using the capital structures of holding companies of LECs earning revenues of $100 million or more annually, including the RHCs. MCI contends that our cost of capital calculation should reflect the RHCs' capital structures, if a represcription is going to affect the BOCs' rates.[321] Other commenters, however, oppose using the RHCs' capital structures. These commenters state that because the RHCs are engaged in cellular, international, and other ventures, their capital structures reflect risks other than those of the LECs alone.[322]

115. SBA supports a capital structure based on a composite of the capital structures of a representative sample of the rate of return LECs. SBA maintains that this alternative would provide a more accurate picture of the financial structure of carriers not subject to price cap regulation than would the other capital structure alternatives.[323] SBA would support a fixed capital structure only if the Commission adopts a capital structure based on a composite of the capital structures of LECs with less than $100 million in annual revenues.[324] MCI states, however, that there is no need for a fixed capital structure at this time. According to MCI, if LEC capital structures change in the future, valid economic reasons may justify use of the actual capital structures.[325]

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[317] Centel Comments at 14-15; Rochester at 28; SNET Comments at 5; SWBT Comments at 3, 8; United Comments at 8-9; USTA Comments at 64-65.

[318] Centel Comments at 14; Rochester Comments at 26; SWBT Comments at 3; United Comments at 6-7; USTA Comments at 59-61.

[319] Centel Comments at 14-16; Rochester Comments at 26; SWBT Comments at 3; USTA Comments at 61.

[320] USTA Comments at 61.

[321] MCI Comments at 29-30. The RHCs own the BOCs.

[322] Centel Comments at 15; Rochester Comments at 24-26; SBA Comments at 16; SWBT Comments at 3; United Comments at 6; USTA Comments at 58-9.

[323] SBA Comments at 16.

[324] Id. at 16-17.

[325] MCI Comments at 30, n.50.

116. FWA opposes using the weighted average cost of capital methodology to estimate the cost of capital for the rate of return LECs. FWA states that small independent LECs do not make public stock offerings and that there is no public information available regarding the value of their stock. Because of this lack of information, FWA states, it is impossible to determine a return using a calculation based on small LEC-specific debt and equity components. FWA argues that determinations of small LEC capital structures often lead to de minimis or even negative equity components, as regulators calculate the equity component by subtracting debt from the net rate base. FWA states that this is clearly incorrect and that we should replace our current RHC methodology with use measures of financial returns. FWA specifically recommends the times interest expense ratio coverage that several major lenders employ in lending to small companies. According to FWA, this ratio gives a better analytical view of the financial condition of small carriers and their shareholder value.[326]

117. United and USTA indicate that we should treat short-term and long-term debt as one component within the capital structure, and the cost of preferred stock as a separate capital structure component. According to these commenters, preferred stock is a separate financial instrument that has its own embedded costs.[327]

118. Rochester and USTA contend that we should not select a capital structure that would be conclusive in future represcription proceedings. These commenters maintain that the appropriate capital structure for the composite will always be changing, because business risks and capital market conditions evolve over time. In their view, a conclusive capital structure could reduce LEC network investment by limiting the equity investment on which an exchange carrier can earn a reasonable return.[328] United agrees and states the capital structure we choose should be presumptive, rather than conclusive, in future represcription proceedings.[329]

### 3. Discussion

119. We adopt a composite capital structure based on the capital structures of all LECs with annual revenues of $100 million or more. This capital structure will have three components: equity, debt, and preferred stock. We combine short-term and long-term debt into one component because, under our cost of debt methodology, we need not distinguish between these two types of debt. We include a separate preferred stock component because,

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[326] FWA Comments at 3-5.

[327] United Comments at 8-9; USTA Comments at 64, 67.

[328] Rochester Comments at 26; USTA Comments at 63-4.

[329] United Comments at 8.

as United and USTA assert, preferred stock is a separate investor-supplied source of funds with its own embedded costs.

120. We will rely on ARMIS data to determine each of these components as well as their weight within the capital structure. We adopt this methodology because, like our cost of debt methodology, it furthers our goal of simplifying future represcription proceedings without sacrificing needed accuracy. Also, like our cost of debt methodology, this capital structure methodology will be presumptive in future represcription proceedings. We will include the results from this methodology in any notice inquiring into whether a represcription proceeding should be initiated.

121. We adopt this presumptive methodology because, as we found in our cost of debt determination,[330] it provides greater promise than any other alternative of furthering our goal of simplifying future represcription proceedings without sacrificing needed accuracy. For instance, relying on holding company capital structures, as MCI recommends, would increase the risks of distortions from the holding companies' nonregulated ventures. In addition, both that methodology and a decision to rely on the actual capital structures of rate of return LECs, as SBA urges, would require that we obtain additional data from the LECs on a routine basis so that they would be available in the event the triggering event occurs. Because our obtaining such data would burden small LECs, we will defer questions regarding whether we should obtain and rely on such data until that time. Finally, we reject FWA's apparent position that we should replace our weighted average cost of capital methodology with one that relies on small LECs' income in relation to interest expenses. While FWA does not describe how a methodology that compares income to interest expenses would work, the times interest expense ratio is usually used by financial analysts and lenders to assess the long-term risks of insolvency of firms such as small LECs.[331] Those risks differ from the risks that small LECs face in providing interstate access services.

## G. State Cost of Capital Determinations

### 1. Overview

122. Section 65.201 of our rules[332] requires RHCs to provide information related to their operating companies' prescribed intrastate rates of return in their initial submissions. This information must include each state cost of capital determination that is applicable to the BOCs' intrastate exchange carrier operations as of the initial submissions' due date as well as a certified copy of each state decision establishing those costs of capital. In represcription proceedings, these data serve as a check on the reasonableness of other cost of capital

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[330] See infra Section V.D.

[331] Clyde P. Stickely, Financial Statement Analysis: A Strategic Perspective, 389 (2nd ed. 1993).

[332] 47 C.F.R. §65.201.

estimates.[333]

123. In the Notice, we invited comment on whether we should require the filing of state cost of capital determinations applicable to the largest of the rate of return LECs in lieu of, or in addition to, the RHC-related determinations that must be filed under our current rule. To reduce the burden of our filing requirements, we proposed to eliminate the requirement that the copies of the state decisions be certified.[334]

### 2. Comments

124. We received only one comment on state cost of capital determinations. Centel states that state cost of capital determinations should not be used as a reasonableness test in determining the cost of capital for LEC interstate access services. According to Centel, comparing state cost of equity determinations with other cost of capital estimates ignores differences among state regulatory programs and the degrees of competition in each state.[335]

### 3. Discussion

125. We agree with Centel in this instance and believe that this requirement should be eliminated. The states now regulate many large LECs under incentive regulation plans similar to our LEC price cap program. Because of this, many of the state cost of capital determinations for BOCs or other LECs with $100 million or more in annual revenues are stale and would be entitled to little or no weight in any represcription proceeding.[336] Even when the determinations are not stale, they provide only indirect information regarding the cost of capital for interstate access service, since they serve only as a check on the reasonableness of the cost of equity figures and as an indicator of trends.[337] In these circumstances, we see no benefit in automatically requiring the submission of this information in our new rules, but we may require the submission of the most recent determinations in future represcription proceedings. These submissions may include the state cost of capital determination for small LECs. Because the states still regulate many of these LECs on a rate or return basis, the state prescriptions may prove useful in evaluating other cost of capital estimates.

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[333] See 1990 Represcription Order, 5 FCC Rcd at 7513, 7528, paras. 53, 180.

[334] Notice, 7 FCC Rcd at 4700, para. 89.

[335] Centel Comments at 16-17.

[336] See 1990 Represcription Order, 5 FCC Rcd at 7513, para. 53.

[337] Id.

## H. Miscellaneous Issues

### 1. Interexchange Carriers

126. Part 65 includes rules for represcribing a rate of return for interexchange carriers that are required by Commission order to be regulated on a rate of return basis.[338] In the Notice, in recognition of our removal of the only carrier that had ever been subject to these rules, AT&T, entirely from rate of return regulation, we proposed to eliminate them. FWA states that represcription hearings for interexchange carriers are unnecessary, primarily because AT&T is under price caps.[339] We agree. Seeing no potential use for these rules, we eliminate them.[340]

### 2. Calculation Specificity

127. Part 65 requires most cost of capital calculations to be carried out to the eighth decimal place.[341] In the Notice, we stated that this degree of specificity was unnecessary and tentatively concluded that cost of capital calculations need only be carried out to two decimal places.[342]

128. FWA supports this proposal.[343] USTA, however, recommends that calculations be carried out to the third decimal place and then rounded to the second decimal place.[344] To ensure meaningful results, we are adopting a rule requiring that the final computed cost of equity, cost of preferred stock, cost of debt, and their weights in the capital structure be accurate to two decimal places. This may require using more specificity in intermediate calculations and analyses as well as the rounding suggested by USTA. We are making the parties and their professional experts participating in represcription proceedings responsible for achieving this level of accuracy in their recommendations for the final results.

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[338] See 47 C.F.R. §§65.500(a), 65.500, 65.510.

[339] FWA Comments at 12.

[340] We will address any issues that may arise regarding Alascom's cost of capital in our tariff review process.

[341] See, e.g., 47 C.F.R. §§65.300, 65.304(d).

[342] Notice, 7 FCC Rcd at 4700, para. 92.

[343] FWA Comments at 12.

[344] USTA Comments at 70.

## VI. Enforcement Procedures

### A. Overview

129. In Docket No. 84-800, we promulgated rules to ensure the carriers' compliance with our rate of return prescriptions.[345] These enforcement rules provide for the automatic refund, with interest, of earnings exceeding "the maximum allowable rate of return."[346] For LECs, we specified that this rate of return equals the prescribed rate of return plus buffer zones of 25 basis points on overall interstate access earnings and 40 basis points on earnings within each of three interstate access service categories -- common line, traffic sensitive, and special access.[347] The enforcement rules require the LECs to monitor their interstate access earnings over two-year periods.[348] When those earnings exceed the "maximum allowable rate of return" on either an overall or an access category basis, the rules state that LECs must refund the excess earnings through prospective rate adjustments or direct distribution to customers.[349]

130. In the Automatic Refund Decision, the D.C. Circuit held that this automatic refund rule constituted arbitrary and capricious agency action in violation of the Administrative Procedure Act.[350] The Court based its decision solely on a perceived contradiction between the refund mechanism and the rate of return prescription it purports to enforce.[351] The Court found the refund rule inconsistent with the view that the rate of return represents a minimum and maximum allowable return, a view the Court attributed to the Commission, because the refund rule could cause a carrier to earn less than the authorized rate of return.[352] The Court stated that "[s]ince the Commission views the rate of return as a minimum, the refund rule under the Commission's view would operate over the long run to

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[345] 47 C.F.R. §§65.700-65.703.

[346] Id. §65.703.

[347] Id. §§65.700(a), 65.702(b).

[348] Id. §65.701.

[349] Id. §65.703.

[350] Automatic Refund Decision, 836 F.2d at 1389 (citing 5 U.S.C. § 706(2)(A) (1982)). See also Ohio Bell Telephone Co. v. FCC, 949 F.2d 864 (6th Cir. 1991) (overturning, as inconsistent with the Commission policies establishing permissible rates of return, a Commission order requiring carriers to refund special access overearnings for 1985 through 1988).

[351] Automatic Refund Decision, 836 F.2d at 1390.

[352] Id. at 1390-91.

put a carrier out of business."[353] The Court remanded this automatic refund rule to the Commission to fashion a refund mechanism that comports with the Commission's understanding of its rate of return prescription.[354]

131. In the Notice, we stated that the prescribed rate of return constitutes a point within a broad range of reasonableness, and not at the same time "both a minimum and maximum" allowable return.[355] This statement reflected our determination in the 1990 Represcription Order that the prescribed rate of return does not represent "a unique balance point such that '[i]f the rate were higher, the balance would tip in favor of the investor; if lower, it would tip in favor of the consumer.'"[356] Our rate of return prescription represents neither the maximum nor minimum point necessary to satisfy the constitutional requirement that an agency rate order "viewed in its entirety" must produce a just and reasonable "total effect" on the regulated business.[357] Instead, we select the prescribed rate of return, based on our consideration of all relevant factors, from a narrower zone within the zone bounded on the lower end by the constitutional minimum.[358] A substantial gap exists between that rate of return and an earnings level that, if sustained over time, would represent an unconstitutional taking of property.[359]

## B. Enforcement Mechanisms

### 1. Overview

132. In the Notice, we stated that we could choose from among a wide range of enforcement mechanisms, including an automatic refund rule, to enforce the prescribed interstate rate of return.[360] We proposed, however, to repeal the automatic refund rule and to

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[353] Id. at 1390.

[354] Id. at 1393.

[355] Notice, 7 FCC Rcd at 4701, para. 96 (quoting Automatic Refund Decision, 836 F.2d at 1390).

[356] 1990 Represcription Order, 5 FCC Rcd at 7532, para. 217.

[357] See FPC v. Hope Natural Gas, 320 U.S. at 602.

[358] Notice, 7 FCC Rcd at 4701, para. 97.

[359] As we explained in the 1990 represcription proceeding, "[i]nvocation of the concept of balancing often conjures an image of a scale, or possibly, and more negatively, a see saw, that can only achieve balance at one point." 1990 Represcription Order, 5 FCC Rcd at 7540, n.313. We continue to believe that the visual metaphor of "a rocking chair that can be made to tip over frontwards or backwards, but that will remain upright through a considerable part of its total range of motion" accurately illustrates the balance of investor and consumer interests that our rate of return prescriptions reflect. Id.

[360] Notice, 7 FCC Rcd at 4702, para. 98.

rely instead on the tariff review and complaint processes to enforce our rate of return prescriptions.[361] We invited interested parties to comment on these proposals.[362]

### 2. Comments

133. Most commenters who addressed this area favor the elimination of the automatic refund rule.[363] Commenters contend that the rule prevents rate of return carriers from operating efficiently and reducing costs,[364] denies consideration of equitable principles in remedying overearnings,[365] and constitutes arbitrary and capricious agency action.[366] Centel argues that the Commission may not, even in complaint actions under Section 208 of the Communications Act,[367] require a carrier to refund overearnings, unless it also allows the carrier to recover underearnings. Because no interexchange revenues and only a small portion of LEC interstate access revenues remain under rate of return regulation, Centel contends that we have less need for an automatic refund rule today than we had at the time of its adoption in 1985.[368] Other commenters maintain that our tariff review and complaint processes will adequately deter violations of our rate of return prescriptions and allow us to correct any violations that occur.[369] U S West agrees and states a carrier that can reduce its expenses below the expected level should retain all resulting profits.[370] Regardless of the enforcement mechanism we choose, USTA and other commenters argue that when carriers exceed the prescribed interstate rate of return, the Commission may grant only prospective

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[361] Id.

[362] Id.

[363] Alltel Comments at 2; Bell Atlantic Comments at 4; BellSouth Comments at 8; BellSouth Reply at 7-8; Centel Comments at 17-18; Lufkin-Conroe Reply at 1-2; NECA Comments at 6-7; NECA Reply at 5-6; NTCA Comments at 7; NTCA Reply at 2-3; NYNEX Reply at 4; OPASTCO Comments at 4; Rochester Comments at 33; USTA Comments at 71; USTA Reply at 11-12; U S West Comments at 3-4; U S West Reply at 4-5.

[364] USTA Comments at 76.

[365] NECA Comments at 6-7; Rochester Comments at 36; USTA Comments at 73.

[366] BellSouth Comments at 3-4; Centel Comments at 21-23; Lufkin-Conroe at 4-5; Rochester Comments at 32-37; USTA Comments at 71-73; U S West Reply at 4.

[367] 47 U.S.C. §208.

[368] Centel Comments at 17.

[369] BellSouth Comments at 7-8; BellSouth Reply at 9; Lufkin-Conroe at 6; NTCA Comments at 7; NTCA Reply at 2; OPASTCO Comments at 4.

[370] U S West Comments at 4; U S West Reply at 5.

relief, not retroactive refunds.[371] NECA and USTA contend that we should measure compliance with our rate of return prescription on an overall interstate access basis.[372] This, they argue, will help average the earnings of NECA's individual pools and, thereby, increase the likelihood that NECA pool participants will earn returns at the authorized level.[373]

134. Only MCI wants the Commission to retain an automatic refund rule.[374] Citing New England Telephone Co. v. FCC[375] and the Automatic Refund Decision,[376] MCI argues that the Commission has the statutory authority to employ a refund mechanism in conjunction with rate of return regulation.[377] MCI believes that the automatic refund rule is consistent with the Commission's understanding of its rate of return prescription, as described in the 1990 Represcription Order.[378] MCI, though, favors modifying that rule to include a special waiver process that allows LECs to seek relief from refund obligations that would have a confiscatory effect.[379] Because of the number and small size of most rate of return LECs, MCI argues an automatic refund rule represents the only efficient way to enforce the rate of return prescription.[380] MCI believes that the Commission should continue to determine violations of the rate of return prescription on a service category-by-service category basis, as well as an overall interstate access basis.[381]

### 3. Discussion

135. We conclude that repealing the automatic refund rule would best serve the

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[371] USTA Comments at 71 (citing Illinois Bell v. FCC, 966 F.2d 1478 (D.C. Cir. 1992) (holding that "the Commission has no authority under [Section] 205 to order the refunds contemplated only under [Section] 204")). See also Centel Comments at 25-27; Lufkin-Conroe at 2-5; Rochester Comments at 33.

[372] NECA Comments at 12; NECA Reply Comments at 10; USTA Comments at 81.

[373] NECA Comments at 12; USTA Comments at 81.

[374] MCI Comments at 30.

[375] 826 F.2d 1101 (D.C. Cir. 1987) (New England Telephone).

[376] Automatic Refund Decision, 836 F.2d at 1392. Even though the Automatic Refund Decision remanded our specific refund rule, it affirmed the holding in New England Telephone, supra, that upheld our statutory authority to order refunds when a carrier has violated an outstanding rate of return prescription.

[377] MCI Comments at 31-32.

[378] Id. at 31 (citing 1990 Represcription Order, 5 FCC Rcd at 7532, para. 217).

[379] Id. at 32.

[380] Id. at 30.

[381] Id. at 31-32.

public interest. We believe that the best policy is to rely instead on the tariff review and complaint processes to enforce our rate of return prescription. Because our price cap initiatives have removed all interexchange and most interstate access revenues from our rate of return regulation, we have far less need for an automatic refund rule today than we had at the time of its adoption in 1985. The reduction in the amount of revenues subject to rate of return regulation has reduced the possible impact of "potential administrative quagmires" caused by determining compliance with our rate of return prescriptions on a case-by-case basis.[382] In addition, as discussed more fully below, the principles we employ in addressing complaints alleging LEC overcharges are well-established and, we believe, no more difficult to implement than would be the approach MCI suggests, which would combine an automatic refund rule and special waiver process. In these circumstances, we believe that relying on our tariff review and complaint processes is the most cost-effective way to deter violations of prescriptions by the remaining rate of return LECs and allow us to correct any violations that do occur.[383]

136. When rate of return LECs file tariffs, unless regulated under our optional incentive program,[384] they propose rates based on their projected costs, including a return calculated using the prescribed interstate rate of return. We review many of these projections before allowing the tariffs to take effect and, where appropriate, suspend or investigate the tariff. If, based on our investigation, we conclude that the tariff would result in overearnings, we require its refiling so that overearnings will not result. In addition, we require the LECs to submit quarterly reports that allow us to monitor LEC earnings.[385] In the event of overearnings, we have the authority, after giving carriers a full opportunity for hearing, to prescribe just and reasonable rates "to be thereafter observed" by the carrier.[386]

137. In addition, our recent experience with complaint actions under Section 208 of the Act[387] demonstrates the effectiveness of our complaint process as a tool for enforcing our

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[382] Phase I Order, 50 Fed.Reg. 41350, 41354 (released September 30, 1985).

[383] BellSouth Comments at 7-8; BellSouth Reply at 9; Lufkin-Conroe at 6; NTCA Comments at 7; NTCA Reply at 2; OPASTCO Comments at 4.

[384] See supra para. 14.

[385] 47 C.F.R. § 65.600(b). See also Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, 1 FCC Rcd 952 (1986), recon. denied, 3 FCC Rcd 5340 (1987).

[386] 47 U.S.C. §205.

[387] Id. §208.

rate of return prescription.[388] In conjunction with Sections 206 and 207 of the Act,[389] Section 208 entitles any person whom a common carrier has injured by its unlawful rates to file a complaint for damages with the Commission. If we find the carrier liable for damages, we can then order the carrier to pay the complainant the amount to which it is entitled.[390]

138. We have received hundreds of complaints from customers alleging that the LECs had charged them excessive rates for interstate access service during each two-year monitoring period beginning with 1985-86.[391] In addressing these complaints, we determine a LEC's liability, if any, for violations of a rate of return prescription.[392] If we find such liability, we then calculate the damages the complainant suffered and award appropriate relief.[393] While not precluding other possible measures of damages, we have, after careful consideration of the arguments and evidence presented in the individual complaint actions, based our damage awards on the difference between the amount the customer had paid and the amount that it would have paid if the LEC had charged rates that produced earnings at the prescribed ceiling. We offset this difference by the amount the customer had underpaid the LEC for services in other access categories during the same monitoring period.[394] These damage calculations reflect the buffer zones the automatic refund rule established.[395] The D.C. Circuit is currently reviewing this approach.[396] We will revisit our decision to eliminate the automatic refund rule if the D.C. Circuit's decision on review warrants such

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[388] See, e.g., MCI Telecommunications Corp. v. Pacific Northwest Bell Telephone Co., 5 FCC Rcd 216 (1990), recon., 5 FCC Rcd 3463 (1990) (MCI Liability Order), appeal dismissed sub nom. Mountain States Telephone & Telegraph Co. v. FCC, 951 F.2d 1259 (10th Cir. 1991) (per curiam); MCI Telecommunications Corp. v. Pacific Northwest Bell Telephone Co., 8 FCC Rcd 1517 (1993) (MCI Damages Order), appeal docketed sub nom. MCI Telecommunications Corp. v. FCC, Nos. 93-1166 et al (D.C. Cir. Feb 18, 1993).

[389] 47 U.S.C. §§206-07.

[390] Id. §209.

[391] In light of our adoption of the sharing and low-end adjustment mechanisms in the LEC Price Cap Order, complaints that overall company earnings that comply with the sharing mechanism are excessive in view of costs will not lie. 5 FCC Rcd at 6802, para. 128.

[392] See, e.g., MCI Liability Order, 5 FCC Rcd 3463.

[393] See, e.g., MCI Damages Order, 8 FCC Rcd at 1517. While we initially handled complaint actions against rate of return LECs in bifurcated proceedings, we have more recently addressed both liability and damages in the same proceeding. See, e.g., ACC Long Distance Corp. v. New York Telephone Co., 9 FCC Rcd 1659 (1994); LiTel Telecommunications Corp. v. U S West Communications, Inc., 9 FCC Rcd 1619 (1994).

[394] Id. at 1525-26, paras. 30-43.

[395] Id.

[396] MCI Telecommunications Corp. v. FCC, Nos. 93-1166 et al. (D.C. Cir. Feb. 18, 1993).

action.

139. We will continue to enforce compliance with our rate of return prescriptions both for service categories and for interstate access overall.[397] Enforcement only on an overall interstate access basis, as USTA and NECA propose, would undermine some of the purposes of our access charge plan. We designed that plan in part to change the relationship among rates for end user services in order to reduce discrimination and preferences within the existing rate structure. That plan requires carriers to target each service category to earn the same return. The same considerations lead us to enforce compliance with our rate of return prescriptions on a service category-by-service category basis.

## C. Buffer Zones and Enforcement Period

### 1. Overview

140. As stated previously, the automatic refund rule establishes buffer zones above the prescribed interstate rate of return of 25 basis points on overall interstate earnings and 40 basis points each on earnings within the common line, traffic sensitive, and special access categories. In the Notice, we sought comment on the reasonableness of these buffer zones for the remaining rate of return LECs, regardless of our action in regard to the automatic refund rule. We also invited comment on whether to change the current two-year enforcement period for monitoring compliance with the rate of return prescription.

### 2. Comments

141. The commenters who address the issue find the current buffer zones inadequate.[398] Several commenters argue that a buffer zone of 100 basis points would recognize fluctuations in demand and operating costs inherent in their regulated industry.[399] MCI states that a wider buffer zone would ensure that our refund mechanisms viewed in their entirety produce a just and reasonable total effect on the regulated business.[400] The commenters also recommend that the Commission maintain an enforcement period of at least two years.[401] Centel, though, contends that the enforcement period should cover the full

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[397] See Phase I Order, 50 Fed.Reg. 41350, 41352 (released September 30, 1985).

[398] Centel Comments at 26; NECA Comments at 9-10; NECA Reply at 3; NTCA Reply at 3; OPASTCO Comments at 4; USTA Comments at 81.

[399] Centel Comments at 26; NECA Comments at 9-10; NECA Reply at 10; USTA Comments at 81.

[400] MCI Comments at 32-33.

[401] NECA Comments at 13; NECA Reply at 10; OPASTCO Comments at 4; USTA Comments at 82.

period a rate remains in effect.[402]

### 3. Discussion

142. We retain buffer zones at their present levels. The current prescribed rate of return is a market-based rate of return that reflects investor expectations regarding, among other matters, the effects of these zones.[403] Any modifications to them might change the risks and opportunities for the carriers subject to our rate of return regulation. While we are not convinced that there is any need to change the buffer zones, we will revisit this issue, if appropriate, when we represcribe the authorized rate of return for LEC interstate access service.

143. As we have explained, buffer zones play an important role in our complaint process, both substantively and procedurally. That experience has made clear that these zones adequately recognize the effects fluctuations in demand and operating costs have on rate of return LECs' earnings, while protecting customers against unreasonably high rates. They also help define whether overearnings have occurred, and the measure of damages when overearnings occur. No commenters has provided persuasive evidence that there is any need to change the buffer zones. We do, however, repeal those portions of our buffer zone rules that apply to interexchange carriers that are no longer regulated on a traditional, rate of return basis.[404]

144. We also retain the two-year enforcement period for monitoring compliance with our rate of return prescription. A two-year period provides sufficient time to reduce the risk of underearnings from targeting errors and demand and cost fluctuations, while providing a reasonable period within which to measure compliance.

## VII. Ordering Clauses

145. Accordingly, IT IS ORDERED, pursuant to Sections 1, 4(i), 4(j), 201-205, 218-220, and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§151,

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[402] Centel Comments at 26-27.

[403] See Illinois Bell v. FCC, 988 F.2d at 1264.

[404] We reserve any issues that may arise regarding possible overearnings by Alascom for our complaint process.

154(i), 154(j), 201-205, 218-220, 403, that Part 65 of the Commission's rules, 47 C.F.R. Part 65, IS AMENDED, as specified in Appendix 4.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

APPENDIX 1

**COMMENTERS**

ALLTEL Service Corporation ("ALLTEL")
The Bell Atlantic Telephone Companies ("Bell Atlantic")
BellSouth Telecommunications, Inc. ("BellSouth")
The Blossom Telephone Company ("Blossom")
Casco Telephone Company ("Casco")
Central Telephone Company ("Central")
Cincinnati Bell Telephone Company (Cincinnati")
Community Service Telephone Company ("Community Service")
Delhi Telephone Company ("Delhi")
Fred Williamson & Associates, Inc. ("FW&A")
Frederick & Warinner
General Services Administration ("GSA")
Hampden Telephone Company ("Hampden")
Kaleva Telephone Company ("Kaleva")
LaHarpe Telephone Company ("LaHarpe")
Lexington Telephone Company ("Lexington")
Ligonier Telephone Company ("Ligonier")
MCI Telecommunications Corporation ("MCI")
Mid-Iowa Telephone Co-op Association ("Mid-Iowa")
National Telephone Cooperative Association ("NTCA")
Nebraska Central Telephone Company ("Nebraska")
Nicholville Telephone Company, Inc. ("Nicholville")
Organization for the Protection and Advancement of Small Telephone Companies ("OPASTCO")
Pacific Bell and Nevada Bell ("Pacific")
Roanoke and Botetourt Telephone Company ("Roanoke")
Rochester Telephone Corporation ("Rochester")
Rochester Telephone Company ("RTC")
Rural Telephone Company, Inc. ("Rural Service")
Scio Mutual Telephone Association ("Scio")
Shenandoah Telephone Company ("Shenandoah")
United States Small Business Administration ("SBA")
Southern New England Telephone Company ("SNET")
Southwestern Bell Telephone Company ("Southwestern")
Topsham Telephone Co., Inc ("Topsham")
United States Telephone Association ("USTA")
United Telephone Companies ("United")
U S West Communications, Inc. ("US West")
UTELCO, Inc. ("Utelco")
Van Horne Coop. Telephone Company ("Van Horne")
Wisconsin State Telephone Association ("WSTA")

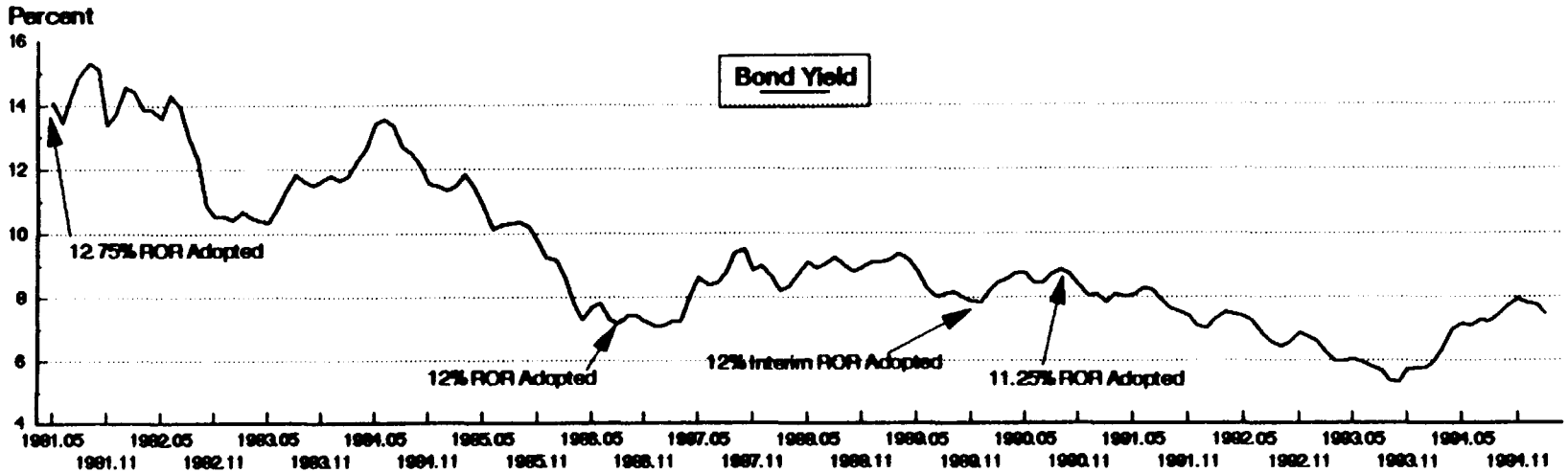
**REPLY COMMENTERS**

The Ameritech Operating Companies ("Ameritech")
BellSouth Telecommunications, Inc. ("BellSouth")
The General Services Administration ("GSA")
Lufkin-Conroe Telephone Exchange, Inc. ("Lufkin")
MCI Telecommunications Corporation ("MCI")
National Exchange Carrier Association, Inc. ("NECA")
National Telephone Cooperative Association ("NTCA")
NYNEX Telephone Companies ("NYNEX")
Pacific Bell and Nevada Bell ("Pacific")
United Telephone Companies ("United")
United States Telephone Association ("USTA")
U S West Communications, Inc. ("US West")

# Appendix 2

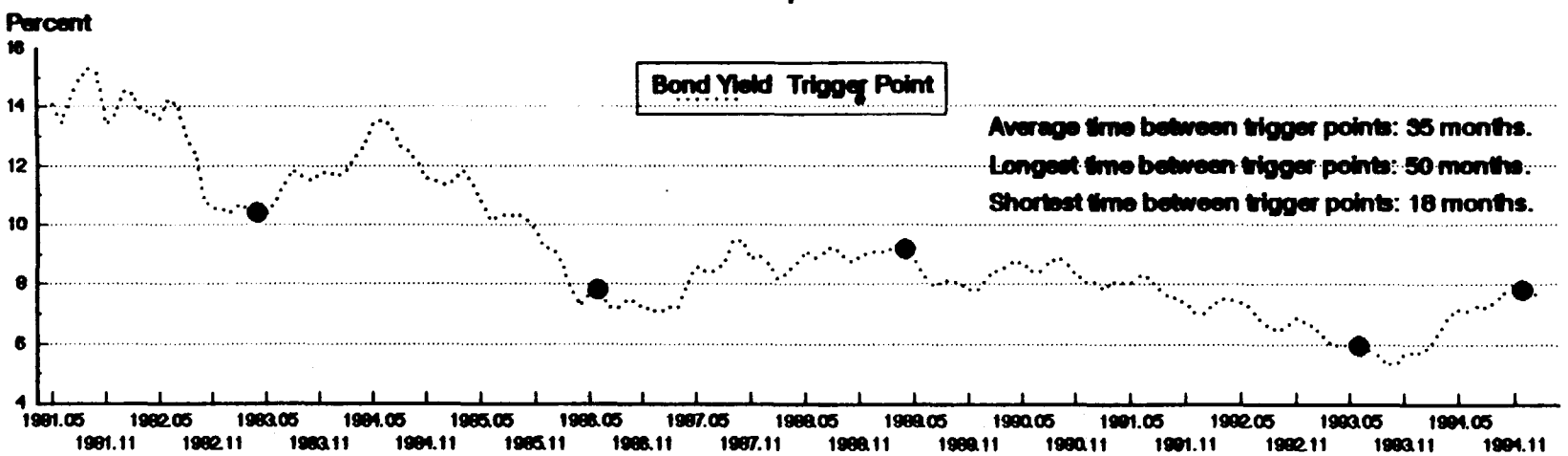
## Chart 1

**10 Year T-Bonds Monthly Avg Yield 5/81 to 2/95**
**Actual Rate of Return (ROR) Prescriptions**




## Chart 2

**10 Year T-Bonds Monthly Avg Yield 5/81 to 2/95**
**Hypothetical Trigger Points from the May 1981**
**Rate of Return Prescription to the Present**

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# Appendix 3

Computation of Equity and Debt Capital Structure and Cost of Debt.
Source: ARMIS USOA Report, FCC Report 43-02, Tables B-1, Balance Sheet Accounts and I-1, Income Statement Accounts. (See note below.)
(Dollars in thousands, except for percentages.)

| Company | Equity Capital 12/31/93 a | Debt Capital 12/31/92 b | Debt Capital 12/31/93 c | Total Capital 12/31/93 d=a+c | Percent Equity Capital e=a/d | Percent Debt Capital f=c/d | Interest and Related Items 1993 g | Average Debt Capital 1993 h=(b+c)/2 | Cost of Debt 1993 i=g/h |
|---|---|---|---|---|---|---|---|---|---|
| [illegible]Tech | 6,341,962 | 5,004,178 | 5,034,379 | 11,376,341 | 55.75% | 44.25% | 352,125 | 5,019,279 | 7.02% |
| [illegible] Atlantic | 9,005,232 | 5,897,482 | 5,750,554 | 14,755,786 | 61.03% | 38.97% | 444,615 | 5,824,018 | 7.63% |
| [illegible] South | 10,743,264 | 7,170,243 | 7,538,620 | 18,281,884 | 58.76% | 41.24% | 587,686 | 7,354,432 | 7.99% |
| [illegible]NEX | 8,103,799 | 6,283,805 | 5,724,879 | 13,828,678 | 58.60% | 41.40% | 519,035 | 6,004,342 | 8.64% |
| Pacific Telesis | 6,355,030 | 5,499,128 | 5,748,934 | 12,103,964 | 52.50% | 47.50% | 438,837 | 5,624,031 | 7.80% |
| Southwestern Bell | 7,151,076 | 4,993,926 | 5,048,721 | 12,199,797 | 58.62% | 41.38% | 385,445 | 5,021,324 | 7.68% |
| US West | 7,675,714 | 5,173,782 | 5,348,270 | 13,023,984 | 58.94% | 41.06% | 394,351 | 5,261,026 | 7.50% |
| [illegible]ntel | 981,780 | 400,962 | 489,910 | 1,471,690 | 66.71% | 33.29% | 45,692 | 445,436 | 10.26% |
| [illegible]ncinnatti Bell | 445,715 | 248,196 | 310,623 | 756,338 | 58.93% | 41.07% | 23,141 | 279,410 | 8.28% |
| GTE/Contel | 9,686,577 | 7,306,362 | 7,374,281 | 17,060,858 | 56.78% | 43.22% | 588,041 | 7,340,322 | 8.01% |
| Rochester Telephone | 666,019 | 481,257 | 381,030 | 1,047,049 | 63.61% | 36.39% | 40,742 | 431,144 | 9.45% |
| Southern New England Tel. | 1,105,631 | 833,494 | 986,100 | 2,091,731 | 52.86% | 47.14% | 67,961 | 909,797 | 7.47% |
| United | 2,115,452 | 1,405,113 | 1,424,286 | 3,539,738 | 59.76% | 40.24% | 113,879 | 1,414,700 | 8.05% |
| Totals | **70,377,251** | **50,697,928** | **51,160,587** | **121,537,838** | **57.91%** | **42.09%** | **4,001,550** | **50,929,258** | **7.86%** |

Note: Debt is the sum of Rows 4020, 4050, 4060 and 420 from Table B-1 of FCC Report 43-02. Equity is from Row 440 from Table B-1 of FCC Report 43-02. Interest and related items is from Table I-1 of FCC Report 43-02.
Only those companies that filed FCC Report 43-02 for both 1992 and 1993 were included in the above table.

## APPENDIX 4--RULES

Parts 65 of the Commission's Rules and Regulations, 47 C.F.R. Part 65, is amended as follows:

### Subpart A - General

1. Rules section 65.1 is revised to read as follows:

**§ 65.1 Application of Part 65.**

(a) This part establishes procedures and methodologies for Commission prescription of an authorized unitary interstate exchange access rate of return and individual rates of return for the interstate exchange access rates of certain carriers pursuant to § 65.102. This part shall apply to those interstate services of local exchange carriers as the Commission shall designate by rule or order, except that all local exchange carriers shall provide to the Commission that information which the Commission requests for purposes of conducting prescription proceedings pursuant to this part.

(b) Local exchange carriers subject to §§ 61.41 through 61.49 are exempt from the requirements of this part with the following exceptions:

(1) Except as otherwise required by Commission order, carriers subject to §§ 61.41 through 61.49 shall employ the rate of return value calculated for interstate access services in complying with any applicable rules under Parts 36 and 69 that require a return component;

(2) Carriers subject to §§ 61.41 through 61.49 shall be subject to §§ 65.600(d);

(3) Carriers subject to §§ 61.41 through 61.49 shall continue to comply with the prescribed rate of return when offering any services specified in § 61.42(f) unless the Commission otherwise directs; and

(4) Carriers subject to §§ 61.41 through 61.49 shall comply with Commission information requests made pursuant to § 65.1(a).

### Subpart B - Procedures

2. Section 65.100, 65.101, 65.102, 65.103, 65.104 and 65.105 are revised to read as follows:

**§ 65.100 Participation and acceptance of service designation.**

(a) All interstate exchange access carriers, their customers, and any member of the public may participate in rate of return proceedings to determine the authorized unitary interstate exchange access or individual interstate exchange access rates of return authorized pursuant to § 65.102.

(b) Participants shall state in their initial pleading in a prescription proceeding

whether they wish to receive service of documents and other material filed in the proceeding. Participants that wish to receive service by hand on the filing dates when so required by Part 65 shall specify in their initial pleading in a prescription proceeding, as specified in §§ 65.103 (b) and (c), an agent for acceptance of service by hand in the District of Columbia. The participant may elect in its pleading to receive service by mail or upon an agent at another location. When such an election is made, other participants need not complete service on the filing date, and requests for extension of time due to delays in completion of service will not be entertained.

**§ 65.101 Initiation of unitary rate of return prescription proceedings**

(a) Whenever the Commission determines that the monthly average yields on ten (10) year United States Treasury securities remain, for a consecutive six (6) month period, at least 150 basis points above or below the average of the monthly average yields in effect for the consecutive six (6) month period immediately prior to the effective date of the current prescription, the Commission shall issue a notice inquiring whether a rate of return prescription according to this part should commence. This notice shall state: (1) The deadlines for filing initial and reply comments regarding the notice; (2) The cost of debt, cost of preferred stock, and capital structure computed in accordance with §§ 65.302, 65.303, and 65.304; and (3) such other information as the Commission may deem proper.

(b) Based on the information submitted in response to the notice described in § 65.101(a), and on any other information specifically identified, the Commission may issue a notice initiating a prescription proceeding pursuant to this part.

(c) The Chief, Common Carrier Bureau, may issue the notice described in § 65.101(a).

**§ 65.102 Petitions for exclusion from unitary treatment and for individual treatment in determining authorized return for interstate exchange access service.**

(a) Exclusion from unitary treatment will be granted for a period of two years if the cost of capital for interstate exchange service is so low as to be confiscatory because it is outside the zone of reasonableness for the individual carrier's required rate of return for interstate exchange access services.

(b) A petition for exclusion from unitary treatment and for individual treatment must plead with particularity the exceptional facts and circumstances that justify individual treatment. The showing shall include a demonstration that the exceptional facts and circumstances are not of transitory effect, such that exclusion for a period of at least two years is justified.

(c) A petition for exclusion from unitary treatment and for individual treatment may be filed at any time. When a petition is filed at a time other than that specified in § 65.103(b)(2), the petitioner must provide compelling evidence that its need for individual treatment is not simply the result of short-term fluctuations in the cost of capital or similar events.

**§ 65.103 Procedures for filing rate of return submissions.**

(a) Rate of return submissions listed in § 65.103(b)(1) and (c) may include any relevant information, subject to the page limitations of § 65.104. The Chief, Common Carrier

Bureau, may require from carriers providing interstate services, and from other participants submitting rate of return submissions, data, studies or other information that are reasonably calculated to lead to a full and fair record.

(b) In proceedings to prescribe an authorized unitary rate of return on interstate access services, interested parties may file direct case submissions, responses, and rebuttals. Direct case submissions shall be filed within sixty (60) calendar days following the effective date of a Commission notice initiating a rate of return proceeding pursuant to § 65.101(b). Rate of return submissions responsive to the direct case submissions shall be filed within sixty (60) calendar days after the deadline for filings direct case submissions. Rebuttal submissions shall be filed within twenty-one (21) calendar days after the deadline for filing responsive submissions.

(c) Petitions for exclusion from unitary treatment and for individual treatment may be filed on the same date as the deadline for filing responsive rate of return submissions. Oppositions shall be filed within 35 calendar days thereafter. Rebuttal submissions shall be filed within 21 calendar days after the deadline for filing responsive submissions.

(d) An original and 4 copies of all rate of return submissions shall be filed with the Secretary.

(e) The filing party shall serve a copy of each rate of return submission, other than an initial submission, on all participants who have filed a designation of service notice pursuant to § 65.100(b)

**§ 65.104 Page limitations for rate of return submissions.**

(a) Rate of return submissions, including all argument, attachments, appendices, supplements, and supporting materials, such as testimony, data and documents, but excluding tables of contents summaries of argument, shall be subject to the following double spaced typewritten page limits:

(1) The direct case submission of any participant shall not exceed 70 pages in length.

(2) The responsive submission of any participant shall not exceed 70 pages in length.

(3) The rebuttal submission of any participant shall not exceed 50 pages in length.

(4) Petitions for exclusion from unitary treatment shall not exceed 70 pages in length. Oppositions to petitions for exclusion shall not exceed 50 pages in length. Rebuttals shall not exceed 35 pages in length.

**§ 65.105 Discovery.**

(a) Participants shall file with each rate of return submission copies of all information, including studies, financial analysts' reports, and any other documents relied upon by participants or their experts in the preparation of their submission. Information filed pursuant to this paragraph for which protection from disclosure is sought shall be filed subject to

cause shown.

(b) Participants may file written interrogatories and requests for documents directed to any rate of return submission and not otherwise filed pursuant to § 65.105(a). The permissible scope of examination is that participants may be examined upon any matter, not privileged, that will demonstrably lead to the production of material, relevant, decisionally significant evidence.

(c) Discovery requests pursuant to § 65.105(b), including written interrogatories, shall be filed within 14 calendar days after the filing of the rate of return submission to which the request is directed. Discovery requests that are not opposed shall be complied with within 14 calendar days of the request date.

(d) Oppositions to discovery requests made pursuant to § 65.105(b), including written interrogatories, shall be filed within 7 calendar days after requests are filed. The Chief, Common Carrier Bureau, shall rule upon any such opposition. Except as stayed by the Commission or a Court, any required response to a discovery request that is opposed shall be provided within 14 calendar days after release of the ruling of the Chief, Common Carrier Bureau.

(e) An original and 4 copies of all information described in § 65.105(a) and all, requests, oppositions, and responses made pursuant to §§ 65.105 (a), (b) and (d) shall be filed with the Secretary.

(f) Service of requests, oppositions, and responses made pursuant to §§65.105(b), and (d) shall be made upon all participants who have filed a designation of service notice pursuant to § 65.100(b). Service of requests upon participants who have filed designation of service notices pursuant to § 65.100(b) shall be made by hand on the filing dates thereof.

3. Sections 65.106 is removed.

**Subpart C - Exchange Carriers**

4. Sections 65.200, 65.201, 65.400, 65.500 and 65.501 are removed.

5. Sections 65.300, 65.301, 65.302, 65.303 and 65.304 are revised and a new section 65.305 is added to read as follows:

**§ 65.300 Calculations of the components and weights of the cost of capital.**

(a) Sections 65.301- 65.303 specify the calculations that are to be performed in computing cost of debt, cost of preferred stock, and financial structure weights for prescription proceedings. The calculations shall determine, where applicable, a composite cost of debt, a composite cost of preferred stock, and a composite financial structure for all local exchange carriers with annual revenues in excess of $100 million. The calculations shall be based on data reported to the Commission in FCC Report 43-02. (See 47 C.F.R. § 43.21). The results of the calculations shall be used in the represcription proceeding to which they relate unless the record in that proceeding shows that their use would be unreasonable.

(b) Excluded from cost of capital calculations made pursuant to § 65.300 shall be those sources of financing that are not investor supplied, or that are otherwise subtracted from

a carrier's rate base pursuant to Commission orders governing the calculation of net rate base amounts in tariff filings that are made pursuant to section 203 of the Communications Act of 1934, 47 U.S.C. 203, or that were treated as "zero cost" sources of financing in section 450 and Subpart G of Part 65 of the Commission's rules. Specially excluded are: accounts payable, accrued taxes, accrued interest, dividends payable, deferred credits and operating reserves, deferred taxes and deferred tax credits.

**§ 65.301 Cost of equity.**

The cost of equity shall be determined in represcription proceedings after giving full consideration to the evidence in the record, including such evidence as the Commission may officially notice.

**§ 65.302 Cost of debt.**

The formula for determining the cost of debt is equal to:

$$\text{Embedded Cost of Debt} = \frac{\text{Total Annual Interest Expense}}{\text{Average Outstanding Debt}}$$

Where:

"Total Annual Interest Expense" is the total interest expense for the most recent two years for all local exchange carriers with annual revenues of $100 million or more.

"Average Outstanding Debt" is the average of the total debt for the most recent two years for all local exchange carriers with annual revenues of $100 million or more.

**§ 65.303 Cost of preferred stock.**

The formula for determining the cost of preferred stock is:

$$\text{Cost of Preferred Stock} = \frac{\text{Total Annual Preferred Dividends}}{\text{Proceeds from the Issuance of Preferred Stock}}$$

Where:

"Total Annual Preferred Dividends" is the total dividends on preferred stock for the most recent two year for all local exchange carriers with annual revenues of $100 million or more.

"Proceeds from the Issuance of Preferred Stock" is the average of the total net proceeds from the issuance of preferred stock for the most recent two years for all local exchange carriers with annual revenues of $100 million or more.

**§ 65.304 Capital structure.**

The proportion of each cost of capital component in the capital structure is equal to:

Proportion in the capital structure =

$$\frac{\text{Book Value of particular component}}{\text{Book Value of Debt + Book Value of Preferred Stock + Book Value of Equity}}$$

Where:

"Book Value of particular component" is the total of the book values of that component for all local exchange carriers with annual revenues of $100 million or more.

"Book Value of Debt + Book Value of Preferred Stock + Book Value of Equity" is the total of the book values of all the components for all local exchange carriers with annual revenues of $100 million or more.

The total of all proportions shall equal 1.00.

**§ 65.305 Calculation of the weighted average cost of capital.**

(a) The composite weighted average cost of capital is the sum of the cost of debt, the cost of preferred stock, and the cost of equity, each weighted by its proportion in the capital structure of the telephone companies.

(b) Unless the Commission determines to the contrary in a prescription proceeding, the composite weighted average cost of debt and cost of preferred stock is the composite weight computed in accordance with Section 65.304 multiplied by the composite cost of that component computed in accordance with Section 65.301 or Section 65.302, as applicable. The composite weighted average cost of equity will be determined in each prescription proceeding.

**§ 65.306 Calculation accuracy.**

In a prescription proceeding, the final determinations of the cost of equity, cost of debt, cost of preferred stock and their capital structure weights shall be accurate to two decimal places.

**Subpart E - Rate of Return Reports**

6. Section 65.600 is revised to read as follows:

**§ 65.600 Rate of return reports.**

(a) Subpart E shall apply to those interstate communications common carriers and exchange carriers that are so designated by Commission order.

(b) ***** Final adjustments to the enforcement period shall be made by September 30 of the year following the enforcement period to ensure that any refunds can be properly reflected in an annual access filing.

(c) Each interexchange carrier subject to §§ 61.41 through 61.49 shall file with the Commission within three (3) months after the end of each calendar year, the total interstate rate of return for that year for all interstate services subject to regulation by the Commission. Each such filing shall include a report of the total revenues, total expenses and taxes, operating